QUANTITY THEORY OF MONEY

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We know that is an inverse relationship between the price of money and price of commodities. It means when price of money decreases, the price of commodities increase and when the price of money increase, the price of commodities decreases. So, it gets clarifies that the price of money changes constantly. Why is there a chance in the price of money? The study of the ‘Quantity Theory of money’ is important to give the answer of this question. In other words, the ‘Quantity Theory of money’ defines the causes of changes in the value of money.

DIFFERENT MEANING OF VALUE OF MONEY

It is true that the price of money refers to its purchasing power. Even then there are following three differences related to the value of money:

(1) **Purchasing Power:** Purchasing power refers to the ability of purchasing goods and services with a unit of money. This purchasing power is often measured in comparative terms. It means what amount of goods and services could be purchased with a unit of money in a base year and what amount of these goods and services can be purchased with that very unit in the current year. Index is also prepared on this bases only.

(2) **Rate of interest :** A meaning of the value of money is also often associated with the rate of interest. In this sense, it is predicted how much interest can be obtained from a certain amount of money in a year.

(3) **Foreign Exchange Rate :** In this sense of money, it is predicted. How many units of foreign money can be purchased with a certain unit of money of a particular country.

In all the above three sense, the value of money can be predicted. But the most common and accurate sense is that which is associated to the purchasing power of money.

DETERMINATION OF VALUE OF MONEY

To understand the ‘quantity Theory of money’ it is essential to know on which factor the value determination of money depends. According to economists, money is also a material. Now if we consider money as a material then its value should be determined just in the way the value of any material is determined. We know that according to common rule of economics, price of any material is determined by the forces of demand and supply. So the value of money is also determined at that point on which a balance is established between the demand and supply of money. To understand the value determination of money, it is essential to understand the meaning of demand and supply of money.

Demand of money :

Money is also demanded like commodities by the people of any country. But there are some differences between demand of any commodity and demand of money. Commodities carry the quality of utility. So people demand commodities to satisfy their utility. But money doesn’t satisfy any utility. Goods are purchased for fulfillment of various requirements with the help of money. In other words people get direct satisfaction through the demand of commodities while they get indirect satisfaction through money.

Supply of money :

By supply of money, we refer to that amount of money which is available for exchange in the economy. As a source of exchange both legal tender money and non-legal tender money are together in the economy. Metallic money and paper money are included in legal tender money while credit instruments fall under the category of non-legal tender money. So all the three metallic money, paper money and credit instruments used in a country are included in the supply of money.

Quantity Theory of Money

This is an old theory related to the value determination of money. The conclusion of this theory is that the value of money is determined by changes taking place in the quantity of money.

There is lacking of solid prof regarding the founder of this popular theory related to determination of value of money. Different economists discuss the names used as the possible founders. The names used as possible founders are- Dauan Zatti, Jean Bodlin etc. Later it was amended by John Locke, David Hume, etc. But the credit of making this theory popular goes to the famous Amercian economist Irving Fisher. So, this theory is popular by the name “Fisher’s Quantity Theory of Money.”

(1) According to **J.S. Mill**, "The value of money, other things being the same, varies inversely as its quantity; every increase of quantity lowers the value and every diminution raising it in a ratio exactly equivalent."

(2) According to Wicksell, "The value or purchasing power of money varies in inverse proportion to its quantity, so that an increase or decrease in the quantity of money, other thing being equal will cause a proportionate decrease or increase in its purchasing power in terms of other goods and thus a corresponding increase or decrease in all commodity prices."

Assumption of Theory: The quantity Theory of Money is based on certain assumptions. In the above definitions of the theory the economists have used the term ‘other factors remain constant.’ Its simple meaning is this theory works only when there is no change in any other thing. The main assumptions of this theory are as follows:

(1) There should be no Change in the Demand of Money

It is essential for the functioning of this theory that the demand of money should stay still. It means there should be no change in the demand of money due to trade, industries, employment etc. So, when the demand will be stable, the value of money will be determined by its supply only.

(2) There should be no Change in the Transaction Completed through barter System

Although the barter system has largely come to an end, it is used for some transactions in a few countries. The quantity theory of money holds the opinion that the barter system is not in use. So, this theory can work only when there is no change in the amount of barter system as there is no role of money in the transactions of these goods.

(3) There should be no change in the amount of Credit Money

Even when there is no legal recognition for the credit money, it is very popular. It is the assumption of this theory that there should be no change in the amount of the use of credit money.

(4) The Ratio between the Credit Money and Money in Circulation should be stable

The quantity theory of money is based on thr assumption that there should be no change in the ratio between the credit money and money in circulation in the country. We know that the commercial banks keep a certain part of their customer’s deposits with them and distribute the remaining in the form of credit. So, there is formation of credit on the basis of this deposit. So this theory won’t in this ratio.

(5) There should be no Change in the Velocity of Circulation of Money

By the velocity of circulation of money we refer to the frequency of period. The quantity theory of money works by considering that the velocity of circulation of money will be stable. So, this theory will work only when there is no change in the velocity of circulation of money.